Office of Chief Counsel
Internal Revenue Service

memorandum

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date: December 20, 1999
to: District Director, Illinois
Attn: Robert Maio
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from: District Counsel, Illinois CC:MSR:ILD

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subject: Rebates

[redacted]
Attn:
[redacted]
EIN: [redacted]
Years: [redacted]-[redacted]
No Power of Attorney on file

I. Issue

Are amounts to be rebated to customers in January of the next tax year based on purchases made by those customers accruable as deductions for the current tax year?

II. Conclusion

If a taxpayer properly elects to change to the recurring item exception method of accounting, it may deduct any rebates which are fixed and determinable in the current tax year, if the amounts are actually paid within the time period prescribed by the Code. [redacted] failed to timely elect to change to this method, and has not otherwise received the Commissioner's permission to change methods. Even if the election had been properly made, the rebates involved in this case may not be accrued unless the taxpayer can show that the customers to whom the rebates were given had made the requisite purchases before the end of the tax year.

III. Facts

The taxpayer maintains two accounts which are used to record the accrual and payment of rebates to certain customers. These rebates are referred to as "[redacted]," and are evidently incentives relating to the customers' success in the resale of [redacted] products. The amount of the

incentives relating to the customers' success in the resale of [redacted] products. The amount of the rebates is specified in contracts with the customers, and varies, with some customers getting larger rebates than others for the same [redacted] product. The contracts provide that the rebates will be applied against the cost of future purchases, although some of the contracts (the "[redacted]") also provide that if the Buyer/Seller relationship terminates, outstanding rebates will be refunded in cash.

Once a product has been shipped to the customer, a sales invoice (at gross amount) is created and the rebate accounted for via a debit to Sales Discount and a credit to Rebate Reserve. When the rebates are issued, the Rebate Reserve Account is debited and Accounts Receivable is credited. The credit memos typically cover multiple sales of one month's duration.

The contracts provide that rebates are to be performed via credit memos issued after payment has been received (and provided that the customer's account is current.) However, the actual practice is that the credit memos are issued during the first two weeks after the end of the month, regardless of whether payment has been receive.

For [redacted] and prior years, the taxpayer's method of accounting for these rebates involved an accrual of unused credit memos at year end, with a resulting adjustment to income depending on the existence of an increase or a decrease over the prior year's accrual. In [redacted], the taxpayer continued this method, but in addition, included the amount of the rebates to be issued in January, [redacted] when it made its determination of the accrual at the end of the year. For [redacted] and [redacted], however, the taxpayer reverted to the method of accounting used in [redacted], and did not include the rebates to be made in January of the next year. On its [redacted] return, the taxpayer once again claimed a deduction for the credit memos issued in January, [redacted].

The taxpayer's [redacted] year was audited, and the claimed deduction for the January rebates was disallowed for lack of substantiation.

IV. Discussion

A. The taxpayer did not properly elect to use the recurring item exception method of accounting.

The regulations under I.R.C. § 461 specifically provide that rebates and refunds are deductible only when economic performance occurs, and economic performance occurs when the rebate or refund is paid or credited. Treas. Reg. § 1.461-4(g)(3). Therefore, rebates and refunds cannot ordinarily be accrued as deductions, even if the amounts involved are fixed and determinable at year end.

Prior to [redacted], the taxpayer utilized a method of accounting for rebates under which it maintained a rebate reserve and made an adjustment to income via Schedule M-1. The January rebates were thereby taken into account in year in which they were credited. In [redacted], for the first time, the taxpayer included the January ([redacted]) rebates in the year end reserve. The taxpayer's [redacted] year was

audited as part of the previous audit cycle, for [redacted]-[redacted]. The deduction for the January [redacted] rebates was disallowed. In [redacted] and [redacted] the taxpayer did not claim a deduction for January rebates.

In our view, these facts show that the taxpayer unsuccessfully attempted to change its method of accounting in [redacted] (when it could have done so without filing a formal request to change) and as a consequence, it may not now use that method.

1. The taxpayer attempted to change its method of accounting on its [redacted] return.

The taxpayer argues that it did not changed its method of accounting, but merely changed its "estimate." In our view, a change in the manner in which an estimate is made is a change in method of accounting where the effect is to include amounts actually credited in a subsequent year, and when such amounts were not previously used in making the estimate.

It should be noted that if the taxpayer contends otherwise, that is, if it contends that it did not attempt to change its method of accounting on its [redacted] return, it has, in effect, conceded that it did not make an election to change to the recurring item method in [redacted]. Therefore, the taxpayer could not use that method in the years you are auditing, there being no other basis than a [redacted] election on which the taxpayer can show that it properly elected to change to the recurring item method of accounting.

This, in turn, means that the rebates could not have been accrued even if they could be shown to fixed and determinable, because they were not paid until the next year. We doubt, therefore, that the taxpayer will pursue the argument that it merely changed how it made its estimate.

2. The method to which the taxpayer attempted to change in [redacted] was a permissible method, if properly elected.

Ordinarily, a taxpayer may not deduct a rebate or refund until "economic performance," in the form of actual payment, has occurred. I.R.C. (h)(2)(C). However, by regulation a taxpayer may adopt a method of accounting for certain liabilities for which "economic performance" has not occurred, but which liabilities are "recurring items." I.R.C. § 461(h)(3) Recurring items are ones for which all events have occurred that determine the fact of the liability, and economic performance (i.e., payment) occurs before the return is due to be filed. Therefore, if properly elected, the "recurring item exception" would permit the taxpayer to accrue and deduct the January rebates, assuming the amounts were fixed and determinable at year end and were paid in time.

3. The taxpayer did not properly elect to change to the recurring item method in [redacted].

In order to change its method of accounting, a taxpayer must obtain the permission of the Commissioner. Normally, this is done by timely filing a request on Form 3115, which has not been done for [redacted]. Therefore, the taxpayer's deduction of the January rebates on its [redacted] return was an impermissible change in method of accounting, absent some other basis for obtaining the Commissioner's approval of the change.

Treas. Reg. § 1.461-5(d)(2)(ii) provides for an alternative method of gaining the Commissioner's approval of a change in method of accounting to the recurring item exception method. It provides that a taxpayer can elect the change by "accounting for the item" on its original timely filed [redacted] return. Treas. Reg. § 1.461-5(d)(2)(ii).[1] Treas. Reg. § 1.461-5(d)(3) permits the election to be made retroactively on the taxpayer's [redacted] or [redacted] return, so long as the taxpayer (1) makes the election on a return filed before October 7, [redacted], and (2) complies with the requirements of subsection (d)(2).[2]

Section 1.461-5(d)(3) requires that the election to use the recurring item exception method be elected by "accounting for the item" on its return. Therefore, in order to prove that it made an election for [redacted], it is not sufficient that the return reflect that the taxpayer is changing to the recurring item exception method. It must actually have a recurring item properly reportable on the return in order to change to that method.

Treas. Reg. § 1.461-5(b) sets for the requirements for using the recurring item exception. They are that (1) the item is recurring, (2) the amount of the item is not material, (3) the all events test is met, and (4) the item is actually paid within a short time after the year is ended, usually measured by the time the return is filed. It is clear that the taxpayer failed to prove that it met any of these requirements of in connection with the attempted election on its [redacted] return.

On its [redacted] return the taxpayer included an amount which it claimed represented the January rebates in its adjustment to Schedule M1. The deduction for this amount, identified as being in Account [redacted], was disallowed by the examining agent. The RAR reflects that the basis for the disallowance was that "Based upon the taxpayer's narrative, the taxpayer states that the year end balance is estimated using the December shipments multiplied by the rebate amount. The taxpayer failed to provide any documentation to support that this liability is fixed and determinable at year ended. In addition, the taxpayer failed to demonstrate that any payments were actually made pertaining to the rebate reserve."[3]

This means that the taxpayer failed to show that there was any item on its return which satisfied the all events test ("fixed and determinable"), and it also failed to show that it had actually made the

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[1] The taxpayer might contend that its [redacted] return works as the election required by subsection (d)(2), inasmuch as the second sentence of subsection (d)(2)(ii) refers to elections for years ending before April 7, 1995. However, Treasury Decision 8593, 60 FR 18742 (April 13, 1995) specifically states that the reference to April 7, 1995, does not change the date for making the election by filing a return.

[2] For purposes of this opinion, we are assuming that the taxpayer's failure to use the recurring item method for [redacted] does not, in and of itself, negate a [redacted] election. However, subject to the review of our national office, we might want to argue that the failure to use the method in [redacted] violates the requirement of § 1.461-5(d)(1) that the method be consistently used, and thus, any [redacted] election was ineffective.

[3] As is discussed below, the recurring item method can only be used if the all events test has been met, which includes the requirement that the item be fixed and determinable.

payments within the required time frame. In addition, the failure of the taxpayer to produce evidence in connection with these items also resulted in a failure to show that the rebates or refunds met the other requirements of being "recurring" and of not being material, although the agent did not reach these points in framing the disallowance.

Under these circumstances, the purported election was not properly made. It is as if the taxpayer had failed to even claim the January rebates on the [redacted] return, but merely recited that it was changing to the recurring item exception method without actually using it. A taxpayer could have only make the election to use the recurring item exception method if it in fact had a "recurring item," and this taxpayer failed to prove that it had such an item on its [redacted] return.

The [redacted] tax year of this taxpayer is now closed. The determination of the agent was not appealed. The taxpayer cannot now come forward and contend that the determination of the agent was incorrect.

It should be noted that the taxpayer cannot now amend its [redacted] return to make the election, since § 1461-5(d)(2)(ii) requires that a [redacted] tax year election be made on a timely filed original return.

B. The amount of the rebates was not fixed and determinable at year end, so they can not be deducted even if the taxpayer could use the recurring item exception method.

As outlined above, we believe that the taxpayer did not effectively elect to use the recurring item exception method on its [redacted] return. However, even if we were to concede that point to the taxpayer, and agree that the recurring item exception method can be used on the [redacted] and subsequent returns, it is our opinion that most, if not all, of the amounts involved do not qualify as "recurring items." This is because in most instances, the fact of the liability cannot be established as of the end of the taxable year, as required by § 1.461-5(b)(i).

Tres. Reg. § 1.461-1(a)(2) prescribes that under the accrual method of accounting, a liability is taken into account when all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.

I.R.C. § 461(h) provides that certain liabilities will not be treated as having satisfied the all events test prior to the time that economic performance has occurred. Treas. Reg. § 1.461-4(g) states that for certain liabilities, payment is required for economic performance, and § 1.461-4(g)(3) includes "rebates and refunds" in that category.

Section 1.461-4(g)(3) states that "In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, "payment" is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price"; i.e., when the rebate is applied for the benefit of the customer.

Therefore, ordinarily, amounts credited or paid for rebates and refunds are deductible only in the year of credit or payment. However, under the recurring item exception method of accounting permitted by Treas. Reg. § 1.461-5, rebates or refunds may be accrued prior to payment if they satisfy the all events test, and if they meet the other requirements of Treas. Reg. § 1.461-5(b).

In order to meet the all events test, the taxpayer must show that the fact of the liability has been established. In the present case, under all the types of rebate contracts, the rebates earned can be utilized only as credit against future purchases. This means that the application of the credits is contingent on a purchase being made subsequent to the one giving rise to the credit. In order to establish the "fact of the liability," the taxpayer must be able to demonstrate that the January rebates it wants to accrue were to be applied against purchases made after the credit was earned but before the end of the tax year. If the subsequent purchase is not made before the end of the tax year, then the amount of the credit is not "fixed and determinable" at year end.

The taxpayer contends that rebates arising under the refund contracts meet the "all events" test in that the obligation to pay the refund is fixed and determinable at the end of the year, regardless of whether a subsequent purchase has been made. The basis for this claim is that the rebates were subject to refund without regard to any subsequent purchases, because the refund contracts required the taxpayer to refund the rebates if the customer stops buying from the taxpayer. Thus, the taxpayer contends, unlike the other rebates, there was not a contingency for payment that had not been satisfied in [redacted].

We do not agree with the taxpayer that the existence of a refund is fixed and determined at the end of the year, unless the taxpayer can show that the customer had terminated the Buyer/Seller relationship before the end of the year and thus was entitled to a refund. This is because, under the contract, the amount that the taxpayer is required to refund is not an amount certain, but rather, the balance owed after taking into account amounts credited against purchases. If there is a balance of $100 in the customer's refund account as of December 31, the end of the tax year, and the taxpayer continues as a customer but does not make another purchase until the next November, when it buys $60 worth of merchandise, the amount of the refund will be reduced if the customer then decides to terminate the relationship.

This opinion is subject to review in our national office, which normally should occur within ten working days of the date of this memorandum. We will advise you if the national office recommends any changes in this opinion.

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